

Office of Chief Counsel
Internal Revenue Service

memorandum

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DDHelfgott

date: 4/16/02

to: [REDACTED]
Team Manager

from: Associate Area Counsel (Industry Programs)
(Financial Services: Manhattan)

subject: In re: [REDACTED] Company (f/k/a/ [REDACTED]
[REDACTED] Company)
[REDACTED] and [REDACTED]

ISSUE

Whether the taxpayer's deduction for dividends received is subject to the limitations provided by I.R.C. §§ 805 and 812.

ANALYSIS

The taxpayer is an insurance company whose primary line of business consists of guaranteed investment contracts which are considered group annuities. These contracts have both a general and a separate account component, depending on the investment choice made by the policyholder. If the policyholder chose a fixed return (guaranteed interest), the reserves and corresponding assets were held in the general account. However, the policyholder could also chose a number of variable investment choices, in which case the assets and corresponding reserves were held in the separate account. There was no guaranteed death benefit offered under these contracts. The contracts contained permanent purchase rate guarantees under which annuitization conversion rates for premiums paid during the first [REDACTED] years of the contract were guaranteed. During the years at issue, approximately [REDACTED] of its business was held in segregated asset accounts.

Since [REDACTED], the taxpayer has taken the position it does not qualify as a life insurance company under I.R.C. § 816 because its reserves for its life insurance contracts were not computed using recognized mortality tables. However, pursuant to I.R.C. § 832(b)(4), (flush language), it computes its reserves for such contracts under I.R.C. § 807. We express no opinion as to whether the taxpayer's interpretation of section 816 as applied

to its reserves is correct. The sole issue under consideration in this memorandum is the applicability of I.R.C. §§ 805 and 812 to the taxpayer's deduction for dividends received. On its original returns for the [REDACTED] and [REDACTED] tax years, the taxpayer computed its dividends received deduction applying the limitations under these provisions. The taxpayer subsequently filed a claim for an additional dividends received deduction in the amounts of \$[REDACTED] and \$[REDACTED], respectively, for the [REDACTED] and [REDACTED] tax years. In the claim, the taxpayer takes the position that as it is an "insurance company other than a life insurance company," the only applicable limitation is that provided by I.R.C. § 832 (b)(5). For the reasons set forth below, we concur with this conclusion.

Part I of Subchapter L contains provisions applicable to life insurance companies. I.R.C. § 803 defines life insurance gross income and I.R.C. § 805 identifies the general deductions allowable to such companies. I.R.C. § 805(a)(4)(A) provides that a life insurance company is allowed the deductions provided by sections 243, 244, and 245 (with certain modifications as specified in section 805(a)(4)(B)), as follows: With respect to "100 percent dividends," (defined in section 805(a)(4)(C)) there is no limitation on the deduction. With respect to dividends other than "100 percent dividends," the deduction is limited to the "life insurance company's share" of such dividends. The term "life insurance company's share" is defined for purposes of section 805(a)(4) in section 812. Since section 812 applies for purposes of section 805(a)(4), and all of the deductions provided by section 805 are "for purposes of this part," i.e., Part I, a literal reading of the statute supports the conclusion that these provisions would not be applicable to nonlife insurance companies.

Part II of Subchapter L contains provisions applicable to insurance companies other than life insurance companies. I.R.C. § 832(c) identifies the general deductions allowable to such companies. In section 832(c)(12), it includes as a deduction the special deductions allowed by part VIII of Subchapter B (section 241 and following, relating to dividends received). However, I.R.C. § 832(b)(5), as applicable herein, provides the following:

832 (b) (5) (A) IN GENERAL.--The term "losses incurred" means losses incurred during the taxable year on insurance contracts computed as follows:

832 (b) (5) (A) (i) To losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year.

832(b)(5)(A)(ii) To the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year.

* * *

832(b)(5)(B) REDUCTION OF DEDUCTION.--The amount which would (but for this subparagraph) be taken into account under subparagraph (A) shall be reduced by an amount equal to 15 percent of the sum of--

832(b)(5)(B)(i) tax-exempt interest received or accrued during such taxable year,

832(b)(5)(B)(ii) the aggregate amount of deductions provided by sections 243 , 244, and 245 for--

832(b)(5)(B)(ii)(I) dividends (other than 100 percent dividends) received during the taxable year, and

832(b)(5)(B)(ii)(II) 100 percent dividends received during the taxable year to the extent attributable (directly or indirectly) to prorated amounts, and

832(b)(5)(B)(iii) the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies.

As indicated above, in general, property and casualty companies must reduce their deduction for losses incurred by 15 percent of the amount of tax-exempt interest and deduction for dividends received. This reduction applies to losses incurred on life insurance contracts as well as property and casualty contracts. The references to the application of this limitation to life insurance contracts makes it clear Congress believed section 832(b)(5), and not section 812, applied to the life insurance contracts held by nonlife companies. This is also reflected in the legislative history to the 1986 amendments to section 832 which first imposed limitations on the deductions allowable to property and casualty companies to the extent funded by income not subject to tax. Congress described then present

law as follows:

Unlike life insurance companies, property and casualty investment companies are not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction where deductible additions to reserves are funded with tax-exempt income (or with the deductible portion of dividends received). In the case of life insurance companies, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the prorated policyholders' share of tax-exempt interest (sec.812).

H. Rep. No. 99-426, 99th Cong., 1st Sess., p. 670 (1985).

The purpose for both limitations on the dividends received deduction is to prevent deductible increases in reserves from being funded by tax-exempt income. Ibid. For this reason, section 812 computes the company's share with reference to section 807, which includes the rules for computation of life insurance reserves held by life insurance companies. See, § 812(b)(2)(A). Pursuant to I.R.C. 832(b)(4) (flush language), nonlife insurance companies must compute their life insurance reserves under section 807. It therefore could be argued that section 812 should apply to the extent a nonlife company holds life insurance reserves subject to section 807. However, there is no indication in either the statute or the legislative history that Congress intended section 812 to apply to nonlife companies. In our view, in absence of a Congressional directive to this effect, this argument is not well-founded.

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By: _____
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